3 Lease Aid

SUMMARY

Charter schools are not allowed to issue bonds or levy taxes to pay for building space. Instead, the state provides lease aid that reimburses charter schools for a large portion of building lease costs. Charter school administrators view lease aid as essential to charter schools' financial viability. Without it, charter schools would have to rely on general education aid to pay for a school building. Although good comparisons are difficult to make, charter school lease rates appear to be reasonable when compared to rates state government pays to lease office space. In addition, charter schools generally lease less space than the amount called for in Minnesota Department of Education guidelines. Although state law prohibits charter schools from issuing bonds and from acquiring buildings with state funds, 11 charter schools have established affiliated nonprofit building corporations that issued bonds or obtained loans to acquire school buildings. Charter schools then leased the building from the affiliated corporation. We think the time is right for the Legislature to once again weigh the advantages and disadvantages of allowing charter schools to buy buildings.

Under state law, charter schools cannot use state funds to acquire land or buildings.[1] They are also prohibited from levying taxes or issuing bonds, methods used by traditional school districts to pay for facilities.[2] As a result, charter schools lease space from a variety of public and private entities. Recognizing that operating capital revenue included in the general education formula was not sufficient to fund appropriate facilities as well as other capital needs, the 1997 Legislature established building lease aid to help charter schools pay for leased space.[3]

This chapter addresses the following question:

- **Is the lease-aid program an effective way to help charter schools obtain school facilities?**

To answer this question, we interviewed Minnesota Department of Education (MDE) staff about the lease aid program, and we analyzed data collected by MDE on lease expenditures and lease aid payments for charter schools operating in

1 *Minn. Stat.* (2002), §124D.11, subd. 7.

2 *Minn. Stat.* (2002), §124D.10, subd. 25(b).

3 *Laws of Minnesota* (1Sp1997), ch. 4, art. 5, sec. 13.

fiscal year 2003. To determine the reasonableness of lease expenditures, we compared the rates that charter schools pay for leased space to rates that the State of Minnesota pays for leased office space in the same area. In our interviews with charter school administrators and board chairpersons, we included questions about facilities and lease aid. Finally, we interviewed officials from 14 additional charter schools to learn more about their facilities and leasing arrangements.

Because charter schools may not issue bonds or levy taxes, the state provides lease aid to help pay for facilities.

IMPORTANCE OF LEASE AID

If it finds the lease to be appropriate, MDE will reimburse charter schools for 90 percent of the amount they pay to lease building space up to a maximum. For fiscal year 2003, the maximum is $1,500 per pupil unit.[4] Lease aid may not be used for custodial, maintenance, utility, or any other operating costs. Although not the major source of funding,

- **Lease aid is an important component of charter school financing.**

Total lease aid payments (in constant 2003 dollars) increased from $1.3 million in fiscal year 1998, the first year charter schools were eligible to apply for lease aid, to $15.1 million in fiscal year 2003.[5] This increase is due primarily to the increase in the number of charter schools and the number of students attending charter schools. As shown in Figure 3.1, after adjusting for inflation, lease aid has averaged about $1,100 per pupil unit since fiscal year 2001.[6] The sharp increase in lease aid per student between 1999 and 2000 is the result of a change in the lease aid formula. The 1999 Legislature increased the percentage of lease expenditures eligible for reimbursement from 80 to 90 percent.[7]

As shown in Table 2.3 in Chapter 2, lease expenditures accounted for 14 percent of charter school spending in fiscal year 2002. In total, charter schools collected $12.1 million in lease aid in 2002, accounting for 12 percent of their revenues. Total lease aid for fiscal year 2003 will be about $15.1 million, with all but 1 of the 76 charter schools operating receiving lease aid.[8] The amount of lease aid varied widely among schools, ranging from $11,611 to $873,547, with the average school receiving $201,943. Table A.5 in the Appendix provides detailed

4 *Minn. Stat.* (2002), §124D.11, subd. 4. As discussed in Chapter 1, "Pupil Units" equal average daily membership with students weighted by grade level. Average daily membership (ADM) is the sum for all pupils of the number of days of the school year each pupil is enrolled divided by the number of days that school is in session. Lease aid for fiscal year 2003 was less than expected because the 2002 Legislature required MDE to reduce lease aid for all charter schools by an amount sufficient to make retirement contributions for former employees of charter schools that closed without making the required contributions. *Laws of Minnesota* (2002), ch. 392, art. 6, sec. 4. As a result, MDE reduced total 2003 lease aid by $282,210; each charter school's lease aid was reduced by about 1.8 percent.

5 All amounts cited for fiscal year 2003 are preliminary and subject to final enrollment counts. Seventeen percent of 2003 lease aid revenue is deferred until fiscal year 2004.

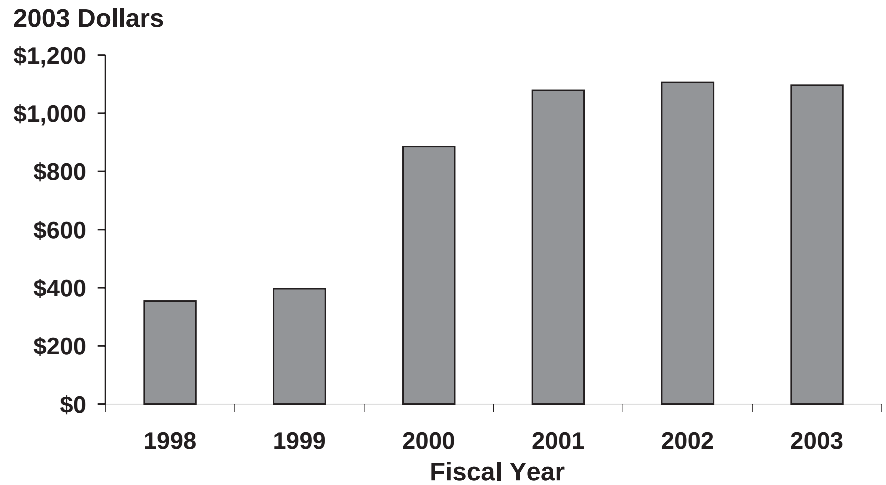
6 Our inflation adjustment was based on the Bureau of Labor Statistics' consumer price index for all urban consumers (CPI-U); http://data.bls.gov/cgi-bin/surveymost; accessed May 16, 2003.

7 The 1999 Legislature also increased the maximum amount allowed from an amount based on the state average debt service revenue plus capital revenue to $1,500 per pupil unit. *Laws of Minnesota* (1999), ch. 241, art. 5, sec. 12.

8 Eci' Nompa Woonspe in Morton owns its building, which it received as a gift, and did not request lease aid.

In recent years, lease aid has averaged about $1,100 per pupil unit.

Figure 3.1: Average Lease Aid Per Pupil Unit, in Constant Dollars, FY1998-2003



NOTE: Pupil units are a measure of average student enrollment weighted by grade level. Dollar values were adjusted for inflation using the Bureau of Labor Statistics' consumer price index for all urban consumers (CPI-U).

SOURCE: Office of the Legislative Auditor analysis of Department of Education data.

information about lease expenditures and lease aid for the charter schools operating in 2003.

Our interviews with charter school administrators included several questions about their building leases and lease aid. We found that:

- **Charter school administrators believe that lease aid is essential to charter schools' financial viability.**

All of the charter school administrators we interviewed said that they rely heavily on lease aid as an integral part of their funding. For example, one charter school administrator said: "Lease aid is extremely important to charter schools. [Our school] would not be financially viable without it." Another administrator pointed out the practicality of lease aid when he commented: "This is a good way to help schools. Giving charter schools bonding options in addition to districts would be a public relations nightmare. The public would not understand why there were multiple bonds." Some charter school officials felt compelled to tell us that lease aid is inadequate. According to one administrator: "This is a great system, and we could use more of it. Why is only 90 percent reimbursed? Even that 10 percent takes away from the program."

Because fiscal year 2003 lease aid is capped at $1,500 per pupil unit, 12 of the 75 charter schools (16 percent) receiving lease aid in 2003 will receive less than 90 percent of their actual lease costs.[9] On average, lease aid will cover about 85 percent of lease expenditures in 2003. The 2003 Legislature reduced the

9 This calculation is before the 1.8 percent reduction in fiscal year 2003 lease aid (see footnote 4).

maximum lease aid payment for new charter schools to $1,200 per pupil unit.[10] This could potentially reduce the amount of lease aid for many new charter schools. For example, had the $1,200 per pupil unit limit been in effect for all charter schools in 2003, 35 (47 percent) would have received lease aid of less than 90 percent of lease expenditures.

REASONABLENESS OF LEASES

State law lists three criteria that MDE must use to determine whether a charter school's request for lease aid will be approved. The criteria are: (1) the reasonableness of the price based on current market values; (2) the extent to which the lease conforms to state laws and rules; and (3) the appropriateness of the lease in the context of the space needs and financial circumstances of the charter school.[11] In addition, charter school buildings must meet state and local health and safety requirements.[12] Charter schools may not lease property from a related party unless the party is a nonprofit corporation or a cooperative.[13]

Due to staff reductions, Department of Education staff no longer make site visits to assess whether lease rates and building space are appropriate.

When it receives a request for lease aid, MDE reviews the lease to determine the reasonableness of the price and the appropriateness of the space. MDE does not use a formula to determine reasonableness. Rather, it considers each lease as a separate case, sometimes comparing the lease to rates paid by other charter schools in the area and sometimes examining local newspaper advertisements or consulting local realtors to determine if the school's rate is consistent with local rates. For fiscal year 2003, MDE assigned one full-time staff person to lease aid and a range of other financial management issues involving charter schools. In prior years, that person was assisted by a supervisor with general responsibility for school facilities who made site visits to examine the suitability of the facility and the appropriateness of its space.[14] The supervisor's position was eliminated in March 2002, and MDE now requires that charter schools submit pictures of the space, recent building inspection and fire marshal reports, and other documentation with the lease aid application. As discussed in Chapter 2, MDE recently eliminated the full-time position and added lease aid responsibilities to another staff position in fiscal year 2004, with 25 percent of that person's time allocated to lease aid.[15]

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10 Existing charter schools would get the greater of $1,200 per pupil unit or the amount of lease aid they received per pupil unit in 2003. *Laws of Minnesota* (1Sp2003), ch. 9, art. 2, sec. 28.

11 *Minn. Stat.* (2002), §124D.11, subd. 4.

12 *Minn. Stat.* (2002), §124D.10, subd. 8. MDE requires that charter school buildings be inspected by the State Fire Marshal's Office for compliance with fire safety codes, be inspected for asbestos by an inspector accredited by the Environmental Protection Agency, meet federal and state laws requiring accessibility for people with disabilities, have an emergency evacuation plan, and comply with an MDE checklist of other health and safety requirements.

13 *Minn. Stat.* (2002), §124D.10, subd. 23a.

14 According to MDE, the supervisor visited most of the new charter schools that opened between 2000 and 2002 and about half of the established schools that had opened in the 1990s.

15 A second person will be responsible for calculating lease aid. Ten percent of that person's time will be devoted to lease aid.

State law requires MDE to consult with the Department of Administration before approving a charter school lease with a for-profit or sectarian organization.[16] MDE routinely sends copies of all new charter school leases to the Department of Administration, but as a practical matter, not until after the leases are signed. Administration Department staff review the leases, sometimes noting terms that could be unfavorable to the school, and return them with attached comment sheets to MDE. Since the leases have already been signed, the Department of Administration's comments have little impact. In general, MDE officials told us that MDE rarely rejects a charter school lease agreement.

To independently assess the reasonableness of charter school lease rates, we compared them to rates that the state pays for leased office space in the Twin Cities metro area and outstate. Table 3.1 presents the results of our analysis. We found that:

- **Charter school lease rates appear to be reasonable when compared to state government leases in the same geographic areas.**

On average, Twin Cities metro-area charter schools paid $11.48 per square foot in 2003 whereas the state paid an average of $16.67 per square foot for its metro-area office space. Outstate differences were smaller: $9.76 per square foot for charter schools verses $11.36 for state offices.

Charter school lease rates compare favorably with rates the State of Minnesota pays for office space.

Table 3.1: Lease Rates Paid by Charter Schools and the State of Minnesota, March 2003

	Metropolitan Area		Outstate	
	Average Rate Per Square Foot	*N*	Average Rate Per Square Foot	*N*
Charter Schools	$11.48	47	$ 9.76	28
State of Minnesota	16.67	141	11.36	285

SOURCE: Office of the Legislative Auditor analysis of data from the departments of Administration and Education.

This comparison has several shortcomings. First, we did not have information on the condition of the state-leased buildings, nor did we have information about the desirability of the location, factors that could influence lease rates. Second, we did not have information about the terms of the state leases, such as whether maintenance and utilities were included. Third, state office buildings may cost more to construct and maintain because they tend to be divided into smaller units (offices or cubicles) than classrooms. Fourth, school buildings may have special requirements, such as space for auditoriums, gyms, cafeterias, and laboratories, which may increase their cost or require remodeling. Some of the charter school lease expenditures included one-time renovation costs that rolled into the lease rate, and others included separate agreements to rent gym space (sometimes from

16 *Minn. Stat.* (2002), §124D.10, subd. 17.

a nearby health club).[17] Nevertheless, we think this comparison provides a general picture of the reasonableness of lease rates.

As a secondary check on the reasonableness of charter school lease rates, we compared a subset of charter school leases to commercial lease rates for some metro area cities using listings on the Minnesota Commercial Association of Realtors web site.[18] Again, we did not have information about the terms of the lease, the condition of the building, or the desirability of the location. In addition, we restricted our comparison to the metro area because there were too few outstate listings. Our analysis indicated that advertised commercial lease rates in the metro area averaged about $12 per square foot. This is above the average rate paid by metro charter schools, but below the rates for metro office space that the state is paying (possibly the result of differences between state and commercial office space or perhaps due to recent market trends not reflected in the state's existing leases).

Lease rates vary considerably among charter schools.

Charter schools' fiscal year 2003 lease rates vary considerably, from a low of $1.95 per square foot to a high of $21.92. From our discussions with school administrators, we learned that schools lease space from a variety of sources. Some have been able to find space at low rates in older, unused buildings owned by a local school district (which is often the school's sponsor), a church, or an affiliated organization. Others have had to lease from private developers at higher rates. For each school, we compared the rate it paid to the rate the state of Minnesota paid for office space in the same city or county.[19] Only seven charter schools paid rates that were more than 10 percent higher than the rates paid by the state for offices in the same city or county. Four of the seven were in Rice County, where the state was paying an unusually low rate for its office space. The other three had additional costs for gym space or had one-time expenses that MDE determined to be reimbursable (such as remodeling or transporting mobile classrooms). Taking these circumstances into account, none of the charter schools appears to be paying an unreasonable rate for its leased space.

The 14 financially stressed charter schools identified in Chapter 2 paid slightly more for their space ($11.40 per square foot) than other schools ($10.70 per square foot). This is primarily because 12 of the 14 charter schools experiencing financial difficulty are in the Twin Cities metro area where lease rates are higher. The 12 metro charter schools in financial difficulty and the 35 other metro charter schools both paid, on average, $11.48 per square foot for leased space.[20]

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17 Gym costs are usually included in the expenditures eligible for lease aid, but the gym's square footage (or a pro-rated amount) is generally not counted as part of the building's square footage. As a result, the rates per square foot for schools that rent gym space outside their buildings are overstated.

18 Minnesota Commercial Association of Realtors, *Minnesota Commercial Property Exchange*; http://www.mncar.org/index.cfm; accessed March 6, 2003. The average is based on advertised rates for office space in Minneapolis, St. Paul, Brooklyn Center, Roseville, Stillwater, and North St. Paul. When a range of rates was listed for a building, we used the midpoint.

19 We used counties when the state did not have leased office space in the same city. Several outstate schools were located in counties with no state offices, but none of these schools were paying rates more than 10 percent above the average rate for all outstate state offices.

20 We identified only two outstate charter schools as being in financial difficulty. Their average lease payment was $10.90 per square foot, slightly above the average rate of $9.67 paid by the 26 other outstate schools.

We also found that:

On average, the amount of space charter schools lease is within Department of Education guidelines.

- **Charter schools lease a reasonable amount of space.**

While not specific to charter schools, MDE has issued square footage guidelines for school building construction. Recognizing that space needs vary according to the programs that the school offers, the guidelines suggest that an average elementary school with less than 500 students needs between 125 and 155 square feet per student; middle schools require 170 to 200; and high schools need 200 to 320 square feet per student.[21] On average, charter schools lease 22,573 square feet of space, or about 150 square feet per student (ADM). This includes classrooms, labs, and offices, and it usually includes auditoriums and cafeterias or lunchrooms. As noted above, it may include gym space.[22] In comparison, MDE data indicate that in 2003, school districts averaged 246 square feet per student.[23] School districts with fewer than 500 students, a group more comparable in size to charter schools, averaged 340 square feet of building space per student. Thus, compared to regular school districts, charter schools use a reasonable amount of space.

Edison Academy in Duluth leased the most space (nearly 114,000 square feet), but it also had the most students (751 ADM). Three schools leased over 300 square feet per student: Hanska Community School, Native Arts High School, and El Colegio Charter School. All of these schools had relatively few students (between 15 and 60) resulting in high costs per student.[24]

LEASING FROM AFFILIATED NONPROFIT BUILDING CORPORATIONS

As noted earlier, state law prohibits charter schools from issuing bonds and from using state funds to acquire buildings. However, we found that:

- **To circumvent the prohibition against using state funds to buy buildings, some charter schools have established affiliated nonprofit building corporations that issue bonds or obtain loans to acquire school buildings.**

21 Department of Children, Families, and Learning, *Guide for Planning School Construction Projects in Minnesota* (Roseville, MN: 2003), 66-68. Amounts exclude swimming pools and space intended primarily for community use.

22 Some schools had arrangements with nearby YMCAs or gym clubs to use their facilities. Typically, the payments for using the gym facilities were included in the lease amount but the square footage was not, thereby overstating the rate paid per square foot for the main school building.

23 Data furnished by MDE, based on 2003 building square footage and 2002 average daily membership for 349 school districts.

24 El Colegio leases from an affiliated company, a topic discussed in the next section. It planned for a larger enrollment than the 60 students it has, and the $1,500 per pupil unit limitation on lease aid means that the school's lease aid is only 57 percent of its lease costs. Hanska Community School has by far the most square feet per student (855). It has only 25 students, and leases a former New Ulm elementary school building that is now owned by a nonprofit corporation. The school paid only $1.95 per square foot in 2003, so its lease costs are manageable. Native Arts High School has only 15 students and is one of the schools we identified as financially stressed. The school recently moved to a smaller facility.

The 11 charter schools that formed affiliated companies to acquire buildings said that they could not find suitable space to lease.

As of fiscal year 2003, 11 charter schools had affiliated nonprofit building corporations that arranged for bonds or loans to purchase a school building. In turn, the charter schools signed leases with the affiliated nonprofits, and state lease aid provided most of the revenue to repay the bonds or loans. We did not assess the legality of this arrangement. According to MDE, the department consulted with the Attorney General's Office in 1999 regarding this type of lease arrangement. The Attorney General provided some analysis of the practice but did not provide an opinion on its legality. We are not aware of any legal challenges to this practice.

We interviewed officials from the 11 schools that chose this route to acquire facilities. All of the schools that formed affiliated nonprofit companies to acquire a building said they did so because they could not find a suitable building for lease in the area where they wanted to locate the school. Two of the schools were leasing property that the owner decided to sell. Unable to find other available facilities, they each formed affiliated nonprofit companies to buy their buildings. Four schools formed affiliated nonprofit companies to purchase and renovate existing buildings. Four schools constructed new buildings. In one case, the building's owner, a nonprofit corporation, created a new nonprofit corporation affiliated with the school after the building was built.

The most common financing mechanism was one in which a city housing and redevelopment agency issued tax-exempt bonds. Principal and interest on the bonds is covered by the lease payments the school makes to the affiliated nonprofit corporation. Eight schools obtained financing in this manner, and two others used a combination of bonds and bank loans. One school was able to obtain all of its financing through a bank loan.

The average lease rate for the 11 charter schools that established affiliated nonprofit corporations to purchase or construct a facility was $12.98 per square foot in 2003, compared with an average rate of $10.47 for the other charter schools. These 11 schools also had more space than other schools (157 versus 147 square feet per student). As a result, the charter schools that established affiliated nonprofit corporations to purchase or construct a facility had lease expenditures in 2003 equal to $1,964 per student compared to $1,408 for the other schools. On the other hand, none of these schools met our criteria for being in financial difficulty. Furthermore, if these schools remain successful and repay the bonds, their costs in the long run may be lower when the bonds are paid off.[25] Any long-term savings on the part of schools would result in a reduction in state-funded lease aid.

One issue raised by the use of affiliated building corporations is whether charter schools should be allowed to own their buildings outright. Most of the charter school administrators we interviewed thought that charter schools that demonstrate sound academic performance and financial stability (for example, those that had their contract renewed after three years and had positive fund

25 Schools would still have to pay for remodeling and renovation of their building as the need arises. MDE's current practice is to allow lease aid to be used to pay for major remodeling or renovation of a building, but not for routine maintenance.

balances) should be allowed to own buildings because it is more cost-effective in the long run. Schools would have to pay for their facilities, but they would not have to pay rates that cover property taxes and provide profits to private developers.

Another issue is whether the state would be at risk by allowing charter schools to own buildings. Administrators at the 11 schools maintained that the individuals at risk if the school closes and stops making lease payments are the bond investors and that neither the municipality that issued the bonds nor the State of Minnesota are financially at risk. Bondholders would presumably take possession of the building if the school closed and could sell it to minimize their losses.

Charter schools' use of affiliated corporations to purchase buildings has introduced a gray area in the state's policy on building ownership.

A few charter school administrators counseled against lifting the ban on building ownership. One administrator noted that charter school boards are, for the most part, made up of teachers and parents who usually lack financial training. He felt that charter school boards might not be able to successfully undertake all the necessary steps to complete a complicated bond deal that provides the greatest benefit to the school. Another administrator was concerned that charter school buildings could be used as a form of land speculation. A group could, theoretically, form a charter school to acquire a building paid for primarily with state lease aid. If property values increase as they normally do, the school could then sell the building for a profit.

CONCLUSIONS

Lease aid is essential to charter schools. Without the ability to raise funds through property taxes, charter schools are dependent on lease aid to help pay for their facilities. Charter schools appear to be entering into reasonable lease agreements, in terms of both lease rates and the amount of space leased.

We think it is a good time to reassess the state's policy prohibiting use of state funds to buy charter school buildings. Leasing charter school facilitates has both advantages and disadvantages. For example, lease transactions are relatively straightforward and leasing may give a charter school more flexibility as its facility needs change. On the other hand, buying a building can be more cost-effective in the long run and would benefit charter schools that want to locate in an area without suitable lease space available. Charter schools' use of affiliated corporation arrangements has introduced a gray area in the state's policy. While the charter schools in these arrangements are leasing their facilities, they are also indirectly using state funds to acquire buildings. The state also has more experience with charter schools since lease aid was established in 1997. With these issues in mind, we think the time is right for the Legislature to once again weigh the advantages and disadvantages of allowing charter schools to buy buildings.

RECOMMENDATIONS

RECOMMENDATION

The Legislature should review and clarify, as needed, the policy on use of state funds to buy charter school buildings.

Whether charter schools should be allowed to buy buildings is a policy decision that takes a variety of factors into account, including potential risks for the state and for charter schools. The Legislature has a range of options available, from maintaining the status quo, to explicitly allowing charter schools to create affiliated nonprofit building corporations, to allowing charter schools to finance the purchase of facilities directly.

If the Legislature were to allow direct ownership, it could require charter schools to demonstrate financial stability before they can use state aid to construct or purchase a building. For example, it could limit this option to charter schools that have been through at least one three-year contract renewal or that meet a financial threshold, such as a minimum fund balance.[26] The Legislature could also require that, if a charter school closes, any net proceeds from the building's sale be returned to the state. Alternatively, if the Legislature decides that charter schools should not be allowed to use state funds to acquire buildings, directly or indirectly, it could prohibit the practice of using affiliated nonprofit building corporations. Should the Legislature choose this course, it would also have to decide how to treat the 11 charter schools that currently use this arrangement.

26 In theory, the marketplace should place restrictions on which charter schools could finance building projects. Charter schools perceived to be in danger of failing would be less likely to attract investors.